Accountability and Transparency
A Guide for State Ownership

Chapter 3

Auditing Performance

This chapter will discuss how to ensure appropriate audit of SOE performance. It will cover three different types of audits, namely internal, external and state audits, discussing their respective role, what kind of information and reports they provide to whom, how and to which point these are disclosed to the public, and what is the relationship of these different auditors with the audit committee.

3.1. Overview

Auditing performance provides credibility to the performance indicators and the performance review process. It also ensures a robust basis for the accountability system, *i.e.* setting objectives, reviewing performance and disclosing information.

The Guidelines cover in their recommendations three different types of audits: internal, external and state audit. Not all SOEs will necessarily be covered by state audits.[1] To ensure an overall robust auditing system and avoid duplication, it is important to clearly define the respective roles of these audits and explain how they complement one another. It is also necessary to define the state's relationship, if any, with these different types of auditors.

Internal auditors have a unique position and can play an important role by scrutinizing governance practices, reporting routines, the implementation of risk-management policies, and internal control processes, etc. The Guidelines recommend that SOEs "*develop efficient internal audit procedures and establish an internal audit function that is monitored by and reports directly to the board and to the audit committee or the equivalent company organ*" (Guideline V.B). The annotations also provide clear guidance on the role and functions of the internal auditors: "*Internal auditors are important to ensure an efficient and robust disclosure process and proper internal controls in the broad sense*". Internal auditors constitute the first level of review of the quality of information concerning the extent to which the organisation has achieved its established objectives. Internal auditors contribute to the improvement of risk-management and control systems, which tend to be in some cases underdeveloped in comparison with the private sector. They are an important instrument to assist SOEs to better identify and evaluate risks. This risk evaluation is becoming more critical with the growing deregulation and internationalization of industries in which SOEs often operate.

The Guidelines also recommend that "SOEs, especially large ones, should be subject to an annual independent external audit based on international standards. The existence of specific state control procedures does not substitute for an independent external audit" (Guideline V.C). This recommendation is based on the analogy that SOEs are the ultimate public companies, as they are owned in fine by the general public, the state being the agent of this general public. They should thus be subject to at least the same level of transparency and disclosure requirements as listed companies. One central consequence is that SOEs should be audited by an **external independent auditor**. In terms of auditing standards, the Guidelines recommend that SOEs be "subject to the same high quality … auditing standards as listed companies".

Finally, the Guidelines recognise the presence of **state or "supreme" auditors**: "The co-ordinating or ownership entity should … have clearly defined relationships with relevant public bodies, including the state supreme audit institutions" (Guideline II.E). The annotations to this Guideline provide further recommendations for the ownership entity: "In particular, the ownership entity should maintain co-operation and continuous dialogue with the state supreme audit institutions responsible for auditing the SOEs. It should support the work of the state audit institution and take appropriate measures in response to audit findings, following in this regard the INTOSAI Lima Declaration of Guidelines on Auditing Precepts." However, the Guidelines are neither specific nor detailed on what should be the role of state auditors in auditing the performance of both the SOEs themselves and the co-ordinating or ownership entity. The annotations mention that "specific state audit and control systems (…) are sometimes considered sufficient to guarantee the quality and comprehensiveness of accounting information". They also mention the possible limits of such state audits: "these specific controls are designed to monitor the use of public funds and budget resources, rather than the operations of the SOE as a whole".

Finally, implementation of the Guidelines also requires that the state "maintain(s) a continuous dialogue with external auditors and specific state control organs… when permitted by the legal system and the state's level of ownership" (Guideline II.F.4).

The audit committee plays a central role in overseeing the relationship with the three types of auditors. Internal auditors should have a direct reporting line to the audit committee, which should ensure their independence, support their work and discuss their findings. The audit committee is also responsible for nominating or appointing external independent auditors and for overseeing the relationship with them. Finally, audit committees should also discuss the results of state audits, and in general ensure that appropriate action is taken upon audit findings.

In sum, the process of auditing performance contains three main elements (see the Italian example in Box 3.1):

- effective internal audit systems are put in place in SOEs;
- SOE financial statements are audited by external and independent auditors according to international standards;
- the role of state audit *vis-à-vis* SOEs and the co-ordinating or ownership entities is clearly defined; their mission is supported and appropriate use of the audits is done.

These topics will be covered in the following pages, providing guidance on processes and main steps which could be undertaken by the state as an owner to ensure appropriate implementation of the Guidelines regarding auditing performance.

Box 3.1. **Audit of SOE performance in Italy**

Internal Audit: In all SOEs, the internal audit office reports directly to the Board, usually every 6 months, on the following matters: evaluation of the efficiency of the internal audit procedures, checks effectively made and possible risk areas. Moreover, the Ministry of Economy and Finance, as the ownership entity, has actively promoted that all SOEs appoint a senior officer (usually the CFO) responsible for the company's accounting procedures and financial statements. This officer is appointed by and reports to the Board of Directors and is accountable to all stakeholders for the Company's Annual Reports and financial data.

External and independent Audit: All SOEs, both listed and unlisted, are subject to an annual audit by independent external auditors, who are appointed by the GSM. The external auditors of SOEs are required to be duly registered by the Italian Securities and Exchange Commission (Consob), to ensure that they meet the same high quality auditing standards of listed companies.

State Audit: The activity of SOEs is supervised and audited by the National Audit Office (Corte dei Conti). An appointed official of NAO attends SOEs' Board meetings and an annual report by NAO on the performance of each SOE is sent to the Parliament.

3.2. Internal audit

"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes."[2] The Guidelines provide in their annotations some useful indication of the main functions of internal auditors: "They should define procedures to collect, compile and present sufficiently detailed information. They should also ensure that company procedures are adequately implemented and be able to guarantee the quality of the information disclosed by the company".

The Guidelines also provide important indications on the authority of internal auditors and necessary means to fulfil this authority: "*To increase their independence and authority, the internal auditors should work on behalf of, and report directly to the board and its audit committee in one-tier systems, to the supervisory board in two-tier systems or the audit boards when these exist. Internal auditors should have unrestricted access to the Chair and members of the entire board and its audit committee. Their reporting is important for the board's ability to evaluate actual company operations and performance.*"

The ownership entity should demand that their portfolio companies have appropriate procedures for internal auditing that meet the *International Standards for the Professional Practice of Internal Auditing*. It should also encourage internal auditors to focus not only on compliance but on risk, *i.e.* on ensuring that the risk management policy is properly implemented. In addition, they could recommend first that internal audits are acted upon and secondly that the internal audit departments of the main SOEs be audited regularly, by the external independent auditors of by the state auditors.

Below is an overview of the key elements that the ownership entity should demand in order to ensure an effective internal audit process in SOEs. The recommendations build on the *International Standards for the professional Practice of Internal Audit* mentioned above.

Table 3.1. **Overview of the key elements that the ownership entity should demand**

Main steps/points	Brief description
Develop appropriate policies regarding the role of audit committees in supporting internal audit	Governance policies or guidelines developed by the ownership entities for SOEs should underline the role of audit committees in supporting the independence and authority of internal auditors. They should also encourage close working relationships between the board, the audit committee and the internal auditors.
	SOE boards and their audit committees should understand the invaluable role of internal auditors to strengthen their own oversight role. They should ensure that internal auditors get sufficient resources and are well positioned within the SOE (*i.e.* at sufficiently high level and separated from functional areas) to guarantee their independence. Internal auditors should also have a direct reporting line to the audit committee.
	Ownership entities should particularly encourage SOE boards and their audit committees to discuss significant risk, control and governance issues with internal auditors.

Table 3.1. **Overview of the key elements that the ownership entity should demand** *(cont.)*

Main steps/points	Brief description
Ensure that appropriate risk assessments are carried out in SOEs	Priorities for the internal audit work are determined based on an analysis of risks faced by the organisation. The evaluation of risk exposure should cover operations, governance and information systems. This risk assessment should be carried out by the chief audit officer, and be discussed with senior management and within the audit committee. The risk assessment plan should be discussed and approved by the entire board or the supervisory board. The ownership entity should pay attention to the implementation of a risk-management system in the company and should be provided with at least a summary of the risk assessment. This is an important element to complete its knowledge of the industry and of the company, and provides a useful perspective for discussing strategy objectives and performance.
Recommend boards to follow up internal audit plans and their implementation	The ownership entities should require internal audits to be acted upon. SOE boards should discuss and follow implementation of internal audit plans. These audit plans should include the evaluation of the relevance and effectiveness of internal control systems. The audit committees should also monitor and assess the effectiveness of internal audits. To this end, the board should ensure that senior management has undertaken appropriate follow-up based on internal audit's recommendations.
Make performance indicators audited by internal auditors	In evaluating the internal control systems, internal auditors could also review to what extent the performance of the SOE is consistent with its established objectives. This includes reviewing criteria or indicators chosen to evaluate performance. This also includes an audit of performance indicators as provided by the information systems.
Encourage appropriate communication among boards, internal and external auditors	SOE governance processes should ensure appropriate co-ordination and communication among the board, external auditors and internal auditors. Ownership entities could develop policies encouraging such communication and remind internal auditors, when reviewing the governance of SOEs, to assess this communication and make recommendations towards its improvements.
Require SOEs to include internal control reports in their annual reports	It is a good practice to include in the financial statements an internal control report describing the internal control structure and procedures for financial reporting. Ownership entities should require SOEs to include such internal control reports in their annual reports and follow up on how effectively they comply with this requirement.

Table 3.1. **Overview of the key elements that the ownership entity should demand** *(cont.)*

Main steps/points	Brief description
Require periodic audit of internal audit departments	SOE boards could require the periodic external audit or quality assessment of internal audit departments, in order to assess the quality of their findings and their status within the SOE. This would emphasise the importance of internal audit for the quality of the information disclosed by the SOE.

3.3. External and independent audit

The annual external audit shall provide the board and shareholders with an independent, critical and objective report on how financial statements have been prepared and presented. They are carried out to ensure that accounts fairly represent the financial position and performance of the company in all material aspects.

The Guidelines recommend that the external audit be based on international standards (Guideline V.C) and "*the same high quality … auditing standards as listed companies*". The use of these standards is expected to significantly improve credibility of the audit performed, and thus of the information provided to the state owner, to other investors as well as to the general public. It will also improve its comparability.

In addition to competence and qualification, one essential consideration is the effective independence of the external auditors. The state as an owner should thus clearly require adherence to relevant principles or standards aiming at reinforcing, among other things, auditors' independence.

An important factor favouring external auditors' independence is the way they are appointed and to whom they are accountable. External auditors should be accountable to the shareholders via the boards, and not to the managers they work with while performing their assignment. Consequently, it is considered as good practice that external auditors are appointed by the AGM following recommendation of the board audit committee.

Table 3.2. **Recommendations on steps that could be taken by the state to ensure that SOE financial statements are appropriately audited by external and independent auditors**

Main steps	Brief description
Require external audit by an independent auditor	Ownership entities should develop a specific recommendation, or refer to a more general code or listing requirements, requiring all SOEs above a certain size to be audited by an external independent auditor. This requirement could be reminded in the ownership policy, the SOE code of corporate governance or any other document related to the transparency and disclosure of SOEs.

Table 3.2. **Recommendations on steps that could be taken by the state to ensure that SOE financial statements are appropriately audited by external and independent auditors** *(cont.)*

Main steps	Brief description
Develop procedures for the selection of external auditors	The ownership entities could develop specific recommendations regarding the selection and appointment of external auditors. Good practice in the private sector calls for external auditors to be recommended by the audit committee of the board or an equivalent body. In the case of fully owned SOEs, external auditors might be appointed directly by the ownership entity, based on the audit committee's recommendation. For partially owned SOEs, the usual good practice applies, *i.e.* nomination by the AGM following recommendation of the board audit committee. In the case of fully owned SOEs, appointment by the ownership entity allows tightening the auditors' accountability as regards the state owner. In any case, the ownership entity should have the capacity to follow the overall process of procurement, from the definition of criteria to the assessment of candidates and final selection.
Define criteria for independence of external auditors	It is crucial that external auditors be independent from the management as well as from large shareholders, *i.e.* the state in the case of SOEs. Criteria for independence should be similar to those used in the private sector. They could include limits on providing consulting or other non-audit services to the audited SOE, as well as periodic rotation of audit partners or audit firms, as mentioned in the annotations of the Guidelines. Ownership entities could develop policies specifying criteria for independence of external auditors. They could take inspiration from the IOSCO standard "*Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence*" which states that – "*Standards of auditor independence should establish a framework of principles, supported by a combination of prohibitions, restrictions, other policies and procedures and disclosures, that addresses at least the following threats to independence: self-interest, self-review, advocacy, familiarity and intimidation.*"
Adopt international audit standards	The state as an owner should require that its large SOEs adopt high-quality internationally recognised auditing standards. This will also depend on the circumstances under which listed companies in the private sector use these standards, for example whether these are used only as an option or for consolidation. It will also depend on the point to which domestic standards can be considered as effectively consistent with international standards.

Table 3.2. **Recommendations on steps that could be taken by the state to ensure that SOE financial statements are appropriately audited by external and independent auditors** *(cont.)*

Main steps	Brief description
Require oversight of the relationship with external auditors by the audit committees	The ownership entities should develop recommendations towards ensuring oversight of external auditors by audit committees. This board oversight underlines the fact that the external auditors are accountable not only to the state shareholder but also to the board. Their duty is to the company and not to the managers they interact with in the course of their audit. Effective oversight of the relationship with external auditors by audit committees is necessary to ensure that the SOE gets appropriate value from this audit. It also requires adequate financial expertise within these committees. The audit committees should also follow the implementation of the audit findings and ensure that external audits, as well as internal audits, are acted upon.
Assess external auditors' work	The ownership entity should be able to assess and effectively review regularly the quality of the external auditors' work. This assessment aims at correcting potential weaknesses and provides input for the selection process. It also provides an opportunity for the owner to clarify its expectations or specific wishes it would have.
Inform on SOEs' external auditors and related fees	The ownership entity could provide information in their aggregate reports and websites on which auditors are auditing SOEs. It could also provide systematic information on the fees received by SOES' external auditors, both for statutory audits and audit-related services.

3.4. State audit

The traditional task of state audit institutions (SAIs) is to audit how government entities use public resources, and particularly the legality and regularity of their financial management and accounting. The objectives of SAIs can usefully be summarised as auditing the "legality, regularity, economy, efficiency and effectiveness of financial management"[3]. SAIs are deemed to be independent institutions and have considerable autonomy. They usually decide on their priorities while still acting as agents of Parliaments, performing audits on their instructions. They are often a powerful tool and information source for the Parliaments.

It is considered good practice that non-listed SOEs be subject to audit by SAIs "if the government has a substantial participation in them – particularly where this is majority participation – or exercises a dominating influence". Such audits should address issues of economy, efficiency and effectiveness.[4] When SOEs are also subject to high-quality external independent audit, SAIs can usefully focus on areas where they complement the external independent audit, *i.e.* performance audits and audits of the ownership entity.

SAIs are also increasingly in charge of performance audits, *i.e.* in-depth reviews of the performance, economy, efficiency and effectiveness of an entity. Performance audits cover the full range of activities, not only the financial operations but also the organisation and all operational systems in place. Since it is recommended that SOEs be audited by external independent auditors, state audits could put more emphasis on auditing performance. As for financial audits, these could be outsourced in some cases to external auditors.

It is important, as recommended in the annotations to the Guidelines, that the ownership entity maintain co-operation and continuous dialogue with the SAI responsible for auditing the SOEs. The Guidelines also recommend ownership entities to support the work of the state audit institution by making appropriate use of their audits and taking action based on their findings.

The following table provides recommendations on what should be the scope and focus of state audits as regards SOEs and ownership entities. It also provides guidance on how to ensure that audits by state audit institutions are useful and lead to appropriate actions.

Table 3.3. **Recommendations on what should be the scope and focus of state audits**

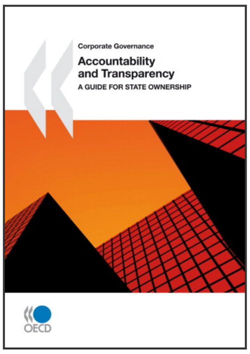
Main steps	Brief description/comments
Define clearly the scope of state audits	The ownership entity could disclose clearly which SOEs are concerned by state audits and what will be the scope and timetable of such audits. The ownership entity could discuss with the SAI and other relevant institutions, such as the Parliament, what could be the most appropriate criteria for submitting specific SOEs to state audit, such as percentage of control, financial results, etc. It could be useful if it could also request the audit of a specific SOE. The scope of state audits could also be discussed on a case-by-case basis to target more specifically the audits according to relevant strategic issues or challenges. A generic discussion could be undertaken on the appropriate scope of such audits, taking into consideration the complementarities with internal and external audits. This could lead to an increased focus on performance audits. State audits institutions should consequently be given the capacity to carry out performance audits on both SOEs and ownership entities.
Ensuring regular in-depth performance reviews of SOEs	Ownership entities could develop a policy through which the SAI will be asked to undertake a performance audit of most SOEs in a regular manner. These performance audits are instrumental in building up the knowledge base of the ownership entity. They will also feed substantially the accountability towards the Parliament. Finally, they might be essential tools for the review of SOE mandates.
Request performance audit of ownership entities	The performance of the ownership entities with regard to the overall objectives of state ownership could also be reviewed regularly by state auditors. The ownership entity should co-operate appropriately and support this audit. This includes providing adequate information and access to staff. The results of the ownership entity review could also be discussed with the Parliament and disclosed to the general public. This could make the general public better informed about the effective behaviour of the state as a shareholder and allow broader participation in related debates.

Table 3.3. **Recommendations on what should be the scope and focus of state audits** *(cont.)*

Main steps	Brief description/comments
Support the work of state audit institutions	The ownership entity could develop guidelines or recommendations supporting and facilitating the audit work of SAIs in SOEs. This will include specific requirements ensuring that SOEs give appropriate access to information, both in terms of access to documents and records, capacity to request complementary information and access to staff.
Discuss results of state audits with SOE boards	Ownership entities could put in place specific processes to discuss in a systematic manner the results of state audits with the concerned boards. These discussions could cover the comments on state audit results as well as action plans prepared by SOE management to address issues identified by the audit. To ensure appropriate co-operation and follow-up action, it is important that the audited entity agrees on the audit findings. Open discussion of these audit findings and agreement on the final report is a critical step in this regard.
Disclose appropriately results of state audits and performance reviews	The ownership entity could adopt a policy by which state audits, including performance reviews of SOEs, are in principle disclosed to the public, or at least meaningful summaries highlighting most strategic issues. An effective means for dissemination of state audits is to post them or their summaries on the SAI's website. However, any disclosure policy in this area should give appropriate consideration to the need for protecting government, commercial, industrial or trade secrets, and not put the SOEs in a difficult situation as regards their competitors.
Take action based on SAIs' audits	Ownership entities and the audited SOEs themselves are required to take appropriate measures in response to audit findings. This includes providing comments on the audit findings in a timely manner and explaining which actions will be taken to remedy weaknesses identified by the audit. The ownership entity could develop a systematic follow-up of actions taken as an answer to audit findings, including asking SOEs concerned to regularly report on these actions and ensure dialogue with the SAI to validate their appropriateness.

Notes

1. In some countries all SOEs, whatever the level of state ownership, will be subject to state audits. In some others, only SOEs with majority state control or full control by the state will be subject to state audit. Whatever the case, the state auditor can in some countries, and often does, outsource financial audits to external auditors.
2. Definition of the Institute of Internal Auditors (*www.theiia.org*).
3. Lima Declaration I. 4.3.
4. Lima Declaration, Section 23. 1. And 23.2.



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